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THE CAPITAL OF A CORPORATION.

THERE has been much discussion of late concerning the alleged evil of over-capitalization of corporations, and a marked tendency to ascribe to this cause a great part of the ills which are charged to large corporate activities.

The human mind ever delights in the discovery of some one definite cause for troublesome conditions, and willingly accepts, often without too close inquiry, theories which are simple in statement, and easily, if but superficially, understood. Therefore, when judges and writers on economic subjects assert that one of the greatest evils from which those dealing with corporations have suffered is over-capitalization — the issue of shares of capital stock to an amount in excess of the value of the capital assets [1] — the statement is gladly accepted, and constitutional conventions, legislatures, and courts vie with each other in declarations against "watered stock," "inflated capital," or "excessive or fraudulent over-capitalization."

The theory underlying these declarations is, that the issue by a corporation of shares of its capital stock, of a specified face or par value, to an aggregate amount in excess of the actual capital of the corporation, is a fraud upon the public, for which the parties to the fraud should be held liable. Granting the premises of this theory, the conclusion may be readily accepted. But the more serious

[1] "And in view of the fact that 'watered' and 'bonus' stock is one of the greatest abuses connected with the management of corporations," per Mitchell, J., in Hospes *v.* N. W. Mfg. & Car Co., 48 Minn. 174, 196.

question remains, what is the capital of the company which is represented by its share certificates, and what are the obligations with respect to such capital which are assumed by the subscribers to, or purchasers of, shares of capital stock?

It makes comparatively little difference to those dealing with a partnership what the members of the firm may have fixed as the firm capital, for not only the firm assets, but all of the individual property of the partners (remaining after payment of their respective personal creditors) is liable to the claims of firm creditors.

But the main object of incorporation for business purposes is to escape this liability, and to limit the possible loss of the associates to the amount contributed or agreed to be contributed by them to the corporate capital.

A recent lecturer in the Harvard Graduate School of Business Administration [1] has formulated the following definition of capital:

> "Capital, considered either as a social and economic or as a business concept, must be viewed as the assets of a going concern, acquired and set aside for productive use."

The general idea of *corporate* capital running through the statutes of the various states is, the amount specified in the Articles of Association as the capital or capital stock of the corporation, which is to be paid in or contributed to it, and to be represented by shares, the holders whereof shall have the right to participate in the net earnings distributed during the corporate life, and to divide among themselves on dissolution all assets remaining after the payment of the corporate debts.[2]

Where it is agreed that this capital fund shall be contributed in cash, the matter is very simple. The amount either has or has not been paid, a fact which may be easily ascertained. Until it is actually paid, those who have agreed to pay are liable to do so, unless the law governing the corporation permits them to devolve that liability upon their transferees. The capital stock of the corporation in that case would be made up of (1) the cash paid in; (2) the unpaid balances which the subscribers have agreed to pay.

But in many instances, the capital which is to serve as the basis

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[1] Cleveland, F. A., Lecture XIII, p. 210.

[2] *E.g.*, "A stock corporation is a corporation having a capital stock divided into shares, and which is authorized by law to distribute to the holders thereof dividends or shares of the surplus profits of the corporation." N. Y. Genl. Corp. Law, § 3.

of the corporate enterprise consists in whole or in part of property, real or personal, or both. It may include copyrights, patent rights, trademarks, good-will, and other "intangible" but valuable property the ownership of which may be the basis of large earning capacity. When all these things are brought in under one ownership and control, the aggregate value may be much more than the sum of the values of the different component parts, separately considered. This added value may have been produced through the efforts of one or more persons who have succeeded in bringing these different elements together, and who are willing to take their compensation in the form of shares representing an interest in the combined capital, thus making their ultimate compensation dependent upon the accuracy of their forecast of the results of the enterprise.

The French law declares that every member of a corporation is a debtor to the corporation for all that he has promised to contribute, such contributions (*apports*) being (1) in money, (2) in kind; and that the sum of these contributions shall constitute the capital stock.[1]

It must be confessed that American statute law and the decisions of American courts have dealt most inadequately with these conditions.

While most courts recognize that as between the corporation and one who has agreed to transfer or convey property to it in exchange for shares of stock, the latter can only be held liable to contribute what he has agreed to; yet a new and different liability, not resting on contract, but created by judicial construction of statutory provisions, and even by applying so-called equitable principles, independently of statutes, has been asserted and enforced in favor of creditors of the corporation.

This liability is not fixed and definite: it is based upon very different and conflicting legal theories, and the bases of its enforcement are so uncertain that in many cases it would be impossible to advise that the holders of stock issued for property might not be held liable to creditors in the event of the future insolvency of the company, no matter how honest the organizers of the corporation might be in their judgment, nor how careful in their estimate of the value of the property acquired as part of the corporate capital.

[1] 2 Traité de Droit Commercial CH. Lyon-Caen et Renault (Paris 1898), p. 12, § 559, p. 397, § 33, p. 25.

This uncertainty in the law has arisen largely through the efforts of the courts to improve on the work of the legislature in cases where the legislative rule seemed inadequate.

It may be doubted whether this effort has been justified by the results attained, and whether the uncertainties and inequalities in the law caused thereby do not constitute a greater evil than that which occasioned the effort at redress.

In the case of corporations operating public utilities, the public has undoubtedly a legitimate interest in the amount of capital stock which may be issued, and the value placed by the organizers upon property acquired as a basis for stock issue, because the reasonableness of rates charged the public for the use of the utilities operated may depend to some extent upon the actual amount of legitimate capital invested in the enterprise, and on which the corporation has concededly the right to earn a fair return.

But, *a priori*, there would seem to be no reason why the incorporators of an ordinary trading or business corporation should not ascribe any value they please to property with which they propose to engage in business, for the purpose of fixing the amount of the capital stock, nor why they should not give an interest in that capital by the issue of certificates representing shares therein to those who may have promoted or brought about the organization, so long as they do not deceive the public or those who may have to deal with the company, either by misrepresentation or suppression of the facts.

The statutes in a number of the states are, however, framed on a different theory, and even where they are not, courts have supplemented them by inventing new grounds of liability in cases where the valuation of property, reviewed after insolvency, has been regarded by the courts as in excess of what should have been the valuation at the time of its acquisition.

Perhaps the greatest uncertainty, and the extremest interference with the finality of the valuation put by the stockholders and directors of a corporation upon property contributed to its capital, exist in New Jersey, — the last state where such conditions would be looked for; the favorite jurisdiction for the formation of large corporations or "trusts."

The General Corporation Law of New Jersey[1] provides that "nothing but money shall be considered as payment of any part

[1] Laws of 1896, § 48.

of the capital stock of any corporation organized under this act, except as hereinafter provided in the case of the purchase of property." "Hereinafter,"[1] it is provided that such a corporation may purchase property necessary for its business,

"and issue stock to the amount of the value thereof in payment therefor, and the stock so issued shall be full paid stock and not liable to any further call, neither shall the holder thereof be liable for any further payment under any of the provisions of this act; and in the absence of actual fraud in the transaction, the judgment of the directors as to the value of the property purchased shall be conclusive."

In Donald *v.* American Smelting Co.[2] the Court of Errors and Appeals (speaking by Dixon, J.) construed these sections in the following language:

"The meaning of section 48 is not questionable. The money must equal the face value of the stock. The language of section 49 is even more explicit. The corporation may issue stock *to the amount of the value* of the property. The value of the property in the one case, just as the value of the money in the other, must at least equal the face value of the stock.

"The distinction between the contemplated issue of corporate stock for property and its issue for money lies, not in the rule for valuation, but in the fact that different estimates may be formed of the value of the property. When such differences are brought before judicial tribunals, the judgment of those who are by law entrusted with the power of issuing stock, to the amount of the value of the property, and on whom therefore is placed the first duty of valuing the property, must be accorded considerable weight. But it cannot be deemed conclusive when subjected to judicial scrutiny. *Nor is it necessary that conscious over-valuation or any other form of fraudulent conduct on the part of these primary valuers should be shown to justify judicial interposition. Their honest judgment, if reached without due examination into the elements of value, or if based in part upon an estimate of matters which really are not property, or if plainly warped by self-interest, may lead to a violation of this statutory rule as surely as would corrupt motive.*"[3]

This decision in effect repeals the statutory rule that the judgment of the directors shall be final except in case of *actual fraud* in the transaction, and substitutes for it the rule that the judgment of the directors is not conclusive if the court shall find that

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[1] § 49.

[2] 62 N. J. Eq. 729.

[3] Pp. 731–2. The italics are the writer's.

their appraisal was made, either (1) without *due* examination — that is, without such examination as the court may deem should have been made — into the elements of value, or (2) upon the basis of matters which the court considers were not proper elements of value, or (3) if, although entirely honest, in the opinion of the court, the judgment of the appraisers might have been warped by self-interest.

In the later case of Easton National Bank *v.* American Brick & Tile Co.,[1] it appeared that a number of gentlemen, including two of the Justices of the Supreme Court of Pennsylvania, in the year 1886 had formed a corporation under the laws of New Jersey to exploit a patented process for making bricks from slate refuse, with a capital stock of $1,000,000, which was to be issued in consideration of the transfer to the corporation of the patents and $25,000 cash. It was a part of the agreement for the formation of the company, that after the stock was issued certain of the subscribers should contribute stock to the amount of $55,000 par value to be used for sale to raise working capital for the company. In 1905, in this suit, brought by the receiver of the corporation, which had become insolvent, the Court of Chancery held that there was "an intentional over-valuation of the property, upon the understanding that a portion of the stock issued should be returned for distribution among the directors voting for the purchase without payment by them," and that this constituted "actual fraud" within the meaning of the statute. It seems to have been assumed by the court that the patents were not worth $1,000,000, largely because no evidence was introduced to show that they had that value. The minutes of the corporation contained no record of the determination of the board of directors to purchase the patents and issue all the capital stock in payment therefor, and the testimony of the witnesses that it had been determined to issue the stock for the patents, and as to a resolution "the contents and purport of which depend upon the recollection of busy men engaged in large and most important enterprises given nearly seventeen years after its adoption," failed to satisfy the Vice-Chancellor "that there was distinct official action by the directors fixing the value of the property and determining that all of the capital stock should be issued to the patentees in payment for their patents." No presumption of regularity in the issue after this period of seven-

[1] 69 N. J. Eq. 327; on appeal, 70 N. J. Eq. 722.

teen years was indulged in. And so the court was of the opinion "that the issue of this stock as full paid, while good as between the parties to it, was a contract made by the company with its stockholders in derogation of the rights of creditors, which should be set aside, and the holders of the stock" [*i. e.*, the original subscribers to it, and the personal representatives of those who were dead] "decreed to pay on account of their holdings, in addition to what they have paid in cash, a sum sufficient to liquidate the debts of the company."

In the Court of Errors and Appeals[1] this liability was affirmed, even (in this respect overruling the Vice-Chancellor) in favor of an executor of a deceased director in and president of the defendant corporation, the executor being himself a creditor in his individual capacity, and its secretary and treasurer at the time the stock was issued; and although the court found "that each of them, at the time they became creditors, knew the exact condition of the company, and knew that the stock in question was not issued for property at its value, as it purported to be." This conclusion was based on the principle that under the New Jersey Corporation Act of 1875 the stockholder's liability to creditors did not depend on the *trust fund* theory or on the theory of *holding out*, but, as Pitney, J., said:

"It depends upon the stockholder's voluntary acceptance, for consideration touching his own interest, of a statutory scheme to which watered stock, under whatever device issued, is absolutely alien, and which requires stock subscriptions to be made good for the benefit of creditors of insolvent companies, without distinction between prior and subsequent creditors, or between creditors who had notice and those who had none."[2]

A different rule was adopted by the United States Circuit Court of Appeals for the Third Circuit in the case of Sternbergh *v.* Duryea Power Co.[3] The defendant there was incorporated under the laws of Pennsylvania[4] which authorized it to acquire patent rights and issue stock "*to the amount of the value thereof.*"

The court held that having taken certain patents at a valuation to which every person in interest agreed, and having enjoyed them for seven or eight years, neither the company nor its trustee in bankruptcy could repudiate the transaction and assess or collect on the full-paid stock which was issued for such patents.

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[1] 70 N. J. Eq. 722.

[2] P. 739.

[3] 161 Fed. 540.

[4] Act of 1874, P. L. 81.

In See, Receiver *v.* Heppenheimer,[1] the foregoing decisions of the New Jersey courts were applied in even more sweeping language. The Vice-Chancellor (Pitney) expressed the opinion that the intention of the legislature expressed in sections 48 and 49 of the Act Concerning Corporations (Revision of 1896) was

"that the capital stock of all corporations should at the start represent the same *value* whether paid for in property or money." "That result," he said, "can only be obtained by supposing that the property is to be appraised at its actual cash value, precisely as if a board of directors with the whole capital stock actually paid in cash is dealing at actual 'arms-length' as real purchasers with the owner of property proposed to be purchased as a real vendor without any interest in the directors to overvalue the property, or other interests inconsistent with the real interest of the stockholders as such. . . .

"After all, it seems to me that the true test, under this statute, as applied to the case here in hand, is this: if the company actually had to its credit in the bank the sum of $5,000,000, would it have been willing to have paid that price in cash for the property in question for the uses and purposes to which it proposed to devote it; would the property be worth that sum in cash to the company?"[2]

If such test should be applied to all the corporations organized under the laws of New Jersey during the past ten or fifteen years, a very considerable number would no doubt be found to have their capital stock not fully paid, and the stockholders, to their great surprise, liable in the event of insolvency for the debts of the corporation.

The Court of Chancery in New Jersey has held

"that a *bonâ fide* transferee of stock, the certificate for which recites that it is full paid, is not liable to make good the contract of the original subscriber, if the transferee has no knowledge that the subscriber has not paid in full nor notice of any fact from which knowledge may be inferred, or which requires him to inquire as to the truth of such statement."[3]

But a liability based on the application of the rule in the See case[4] was there enforced against defendants, no one of whom had made an actual subscription to the stock of the company, but who, having accepted stock without paying for it — *i. e.*, without

[1] 69 N. J. Eq. 36.

[2] Pp. 55–6.

[3] Easton N. Bank *v.* Am. Brick & Tile Co., 69 N. J. Eq. 327, 334.

[4] *Supra.*

paying in property which the court considered to be of equivalent value — were held to be in the position of subscribers.[1]

The United States Circuit Court of Appeals in the Second Circuit has also held that where stock is issued in form as full paid and non-assessable; and is purchased in good faith, in reliance upon such form, as well as upon representations made by the manager of the company that it had been issued for property and was full paid, such purchasers would not be liable to contribute towards the indebtedness of the company, even where it appeared that, as a matter of fact, the stock was issued for much more than the value of the property.[2]

"The doctrine of the best Courts, English and American," says Judge Seymour D. Thompson,[3] "founded on the most obvious conceptions of justice and commercial convenience, now is that where the shares of a corporation are offered for sale by the person named in the certificate, an intending purchaser is not required to look beyond the recitals of the certificate in regard to the title of the vendor or the equities of the corporation, or to suspect fraud in the issuing or payment of the shares, where all seems fair and honest; nor is he bound, for any such purpose, to make an examination of the books of the corporation."

But this rule is not of universal application, and in some jurisdictions even unsuspecting purchasers in good faith of shares of stock issued for property and purporting to be full paid and non-assessable have been held liable to contribute to the indebtedness of the company, or the stock to be void even in the hands of an innocent holder.[4]

The New Jersey courts not only refuse to recognize any finality in the judgment of the corporate organizers, stockholders, and directors, under their own statutes, but they even decline to accept as conclusive the provisions of statutes of other states authorizing the members of corporations to themselves finally determine the value at which they will accept property contributions to the corporate capital.

In Johnson *v.* Tennessee Oil, etc., Co.,[5] a suit brought in New

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[1] P. 78.

[2] Re Remington Automobile and Motor Co., 153 Fed. 345.

[3] 36 Cent. L. J. 96.

[4] See Lake St. El. R. R. *v.* Ziegler, 99 Fed. 114; Smith *v.* Association, 123 Ala. 538; Kellerman *v.* Maier, 116 Cal. 416; First Avenue L. Co. *v.* Parker, 111 Wis. 1.

[5] 69 Atl. 788.

Jersey to collect the amount of a judgment against an Arizona corporation from its stockholders, on the ground that the stock had been issued for property at a gross over-valuation, it appeared that the statutes of Arizona under which the defendant corporation was organized, empowered bodies corporate to exempt the private property of members from liability for corporate debts; that the stock was in fact issued to all of the defendants as full paid and non-assessable, and was all issued and received for property purchased at a valuation agreed on by the incorporators, who at the time of the purchase constituted the board of directors and the only stockholders of the company. No decisions of the Arizona courts were cited on the construction of the statutory provision above referred to, but Vice-Chancellor Emery held that

"On this point I follow what seems to be the plain result of the language of the statute and the charter authorized under it, and conclude that the private property of the defendant stockholders whose stock was issued and received as full paid cannot be taken to pay the corporate debt under this execution." [1]

Notwithstanding this clear recognition of the "plain result of the language of the statute," the court went on to say:

"For a *fraudulent* use of the statutory and charter provisions by the issue of stock for property at a *fraudulent* over-valuation, the holders of stock so issued would, however, remain subject to liability to creditors, under the equitable principles generally referred to as the 'trust fund' theory of capital stock. The capitalization in this case was so grossly excessive as to be fraudulent, and the plaintiff would be entitled to relief on this ground of fraud but for the fact that he was a subsequent creditor with full notice of the fraudulent over-valuation." [2]

This reason for the rule, which gives rise to the last-mentioned exception, is, he says,

"that the right to relief, independent of any statutory provision, so far as it depends upon general principles of equity bearing on the 'trust fund' theory of capital stock, must be based on the creditor's reliance on supposed paid-up capital when the liability was incurred."

Although the learned judge admits that

"the ultimate liability of a stockholder in a foreign corporation for payment of corporate debts depends on the law of the state of incorporation, not on

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[1] P. 791.

[2] P. 791.

the law of the forum, the control of which goes no further than the remedies for enforcing the liability."[1]

This decision was rendered before that of the Court of Errors and Appeals in Easton National Bank *v.* American Brick & Tile Company,[2] which overthrew the entire basis of Vice-Chancellor Emery's judgment, and as above shown, repudiated the "trust fund" theory, and asserted that the stockholder's liability to creditors did not depend on the theory of "holding out," but upon his voluntary acceptance "of a statutory scheme to which watered stock, under whatever device issued, is absolutely alien" — a scheme, be it remarked, which judicial alchemy evolved from a statute authorizing the issue of stock to pay for property, which stock should be full paid and non-assessable, and declaring that "*in the absence of actual fraud in the transaction, the judgment of the directors as to the value of the property purchased shall be conclusive.*"

Perhaps no judicial invention has given rise to as much discussion, or has more unsettled the law than the so-called "*trust fund*" doctrine concerning capital stock.[3]

In the series of cases growing out of the insolvency of the Great Western Insurance Company, an Illinois corporation, the Supreme Court of the United States held that the original holder of stock in a corporation is liable for unpaid installments of stock *without an express promise to pay them*, and that a contract between a corporation or its agents, and the purchaser of stock, limiting his liability therefor is void, both as to the creditors of the company and its assignee in bankruptcy; and that representations by the agent of a corporation as to the non-assessability of its stock beyond a certain percentage of its value constitute no defense to an action against the holder of the stock to enforce payment of the entire amount subscribed, where he has failed to use due diligence to ascertain the truth or falsity of such representations.[4]

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[1] P. 791.

[2] 70 N. J Eq. 722, cited *supra*.

[3] See The Trust Fund Theory of the Capital Stock of a Corporation, by Geo. W. Pepper, 32 Am. L. Reg. N. S. 175; "Capital Stock as a Trust Fund," by Judge Stevenson Burke, 1 West Res. L. J. 5; "Is Unpaid Capital a Trust Fund in Any Proper Sense?" by R. C. McMurtrie, 25 Am. L. Rev. 740; "The Law of the U. S. Supreme Court as to Capital Stock not Fully Paid," by Thomas Thacher, 25 Am. L. Rev. 946.

[4] See Upton, Assignee *v.* Tribilcock, 91 U. S. 45; Sanger *v.* Upton, 91 U. S. 65.

In Sanger *v.* Upton, Swayne, J. said: [1]

"The capital stock of an incorporated company is a fund set apart for the payment of its debts. It is a substitute for the personal liability which subsists in private copartnerships. When debts are incurred, a contract arises with the creditors that it shall not be withdrawn or applied, otherwise than upon their demands, until such demands are satisfied. . . . It is publicly pledged to those who deal with the corporation, for their security. Unpaid stock is as much a part of this pledge, and as much a part of the assets of the company, as the cash which has been paid in upon it. Creditors have the same right to look to it as to anything else, and the same right to insist upon its payment as upon the payment of any other debt due to the company. As regards creditors, there is no distinction between such a demand and any other asset which may form a part of the property and effects of the corporation."

In Coit *v.* Gold Amalgamating Co.[2] the court held that actual fraud in the issue of stock for property would entitle creditors to call the stockholders to account, and that gross and obvious over-valuation of property would be strong evidence of fraud.

In Handley *v.* Stutz [3] Mr. Justice Brown said:

"Ever since the case of Sawyer *v.* Hoag, 17 Wall. 610, it has been the settled doctrine of this court that the capital stock of an insolvent corporation is a trust fund for the payment of its debts, that the law implies a promise by the original subscribers of stock who did not pay for it in money or other property to pay for the same when called upon by creditors; and that a contract between themselves and the corporation that the stock shall be treated as full paid and non-assessable, or otherwise limiting their liability therefor, is void as against creditors. . . ." [4]

"The stock of a corporation is supposed to stand in the place of actual property of substantial value, and as being a convenient method of representing the interest of each stockholder in such property, and to the extent of which it fails to represent such value, it is either a deception and a fraud upon the public, or an evidence that the original value of the corporate property has become depreciated." [5]

"If it be once admitted that a corporation may issue stock without receiving a consideration therefor, and where it does not represent actual or substituted value in corporate assets, there is apparently no limit to the extent to which the original stock may be 'watered' except the caprice of the stockholders." [6]

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[1] At p. 60.
[2] 119 U. S. 343.
[3] 139 U. S. 417.
[4] P. 427.
[5] See p. 428 and following paragraph.
[6] P. 428.

But the application of these views was limited by the court to the *original* issue. As to stock *subsequently* issued, Mr. Justice Brown said:

"The case then resolves itself into the question whether an active corporation, or, as it is called in some cases, a 'going concern,' finding its original capital impaired by loss or misfortune, may not, for the purpose of recuperating itself and providing new conditions for the successful prosecution of its business, issue new stock, put it upon the market and sell it for the best price that can be obtained." [1]

This question the court answered in the affirmative:

"The liability of a subscriber for the par value of increased stock taken by him may depend somewhat upon the circumstances under which, and the purposes for which, such increase is made. If it be merely for the purpose of adding to the original capital stock of the corporation, and enabling it to do a larger or more profitable business, such subscriber would stand practically on the same basis as a subscriber to the original capital. But we think that an active corporation may, for the purpose of paying its debts and obtaining money for the successful prosecution of its business, issue its stock and dispose of it for the best price that can be obtained." [2]

The *decision* in the case was that while persons to whom stock was issued as a mere *bonus* — *i. e.*, without any consideration whatever — were liable to the extent of its par value for the debts of the company, holders of stock issued with bonds as a part consideration for the purchase of the bonds and without which the purchasers would not have bought the bonds, were not so liable.[3]

It is difficult to reconcile this decision with Mr. Justice Brown's statement that

"The wholesome doctrine, so many times enforced by this court, that the capital stock of an insolvent corporation is a trust fund for the payment of its debts, rests upon the idea that the creditors have a right to rely upon the fact that the subscribers to such stock have put into the treasury of the corporation in some form the amount represented by it." [4]

For if the creditors have any such right, there would seem to be no basis for any distinction between the original issue and any sub-

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[1] P. 429. [2] P. 430. [3] P. 435.

[4] *Contra, vide* Welton *v.* Saffery, [1897] A. C. 299; Ooregum G. M. Co. *v.* Roper, [1892] A. C. 125; Wall *v.* Utah Copper Co., 70 N. J. Eq. 17; Vermont Marble Co. *v.* Deelez Co., 135 Cal. 579.

sequent issue. In fact the great weight of authority is against any such distinction.

But, at all events, the *decision* qualifies the basis for this "wholesome doctrine," by limiting the permitted reliance of the creditors to the *original* stock issue. As to *subsequent* issues, neither they nor the purchasers of the stock can tell what rights the creditors may have with respect thereto. They would depend upon proof of the circumstances under which the stock was issued, and whether or not the court should conclude that it was issued "merely for the purpose of adding to the original capital stock of the corporation and enabling it to do a larger or more profitable business" — in which case the stockholder would be liable to pay up the difference between what he had paid in on the stock and its par value; or that it was issued by "an active corporation" "for the purpose of paying its debts and obtaining money for the successful prosecution of its business," and was disposed of for the best price that could be obtained.

No logical basis for this distinction is stated by the court, and if there is a legal presumption that every dollar in par value of stock issued represents a dollar in cash or a dollar's worth of property in the corporate treasury, — which is really the foundation of the so-called "trust fund" theory, — then the purchaser of stock from the company for less than par, whether an original or a subsequent issue, is bound to respond to the claims of creditors for the difference between the amount so paid and par. This is the view which has prevailed in other jurisdictions.

The "trust fund" theory was ably analyzed and repudiated by the Supreme Court of Minnesota, in Hospes *v.* Northwestern Mfg. & Car Co.[1] Mitchell, J., writing the opinion, said:

"This 'trust fund' doctrine, commonly called the 'American doctrine,' has given rise to much confusion of ideas as to its real meaning, and much conflict of decision in its application. To such an extent has this been the case that many have questioned the accuracy of the phrase as well as doubted the necessity or expediency of inventing any such doctrine. While a convenient phrase to express a certain general idea, it is not sufficiently precise or accurate to constitute a safe foundation upon which to build a system of legal rules.[2] . . . There is also much confusion in regard to what the 'trust fund' doctrine applies. Some cases seem to hold that unpaid subscribed capital stock is a trust fund, while other assets are

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[1] 48 Minn. 174; 50 N. W. 1117.

[2] P. 192.

not, — that is, so long as the subscription is unpaid, it is held in trust by the corporation, but, when once paid in, it ceases to be a trust fund; while other cases hold that, paid or unpaid, it is all a trust fund."[1]

The New York courts also have entirely repudiated the "trust fund" theory of capital stock.

"Strictly," says Andrews, J., in Christensen *v.* Eno,[2] "the capital stock of a corporation is the money contributed by the corporation to the capital, and is usually represented by shares issued to subscribers to the stock on the initiation of the corporate enterprise.

"There are unquestioned public evils growing out of the creation and multiplication of shares of stock in corporations not based upon corporate property. The remedy is with the legislature. But the liability of a shareholder to pay for stock does not arise out of his relation, but depends upon his contract, express or implied, or upon some statute, and in the absence of either of these grounds of liability we do not perceive how a person to whom shares have been issued as a gratuity has, by accepting them, committed any wrong upon creditors, or made himself liable to pay the nominal face of the shares as upon a subscription or contract."[3]

The New York Manufacturing Corporation Act of 1848 made stockholders liable for the debts of the corporation "until the whole amount of capital stock fixed and limited by the Company shall have been paid in and a certificate thereof made and recorded."[4]

In National Tube Works *v.* Gilfillan,[5] the court held that all that was required by this statute to make a stockholder liable was that a valid debt should be contracted under the circumstances therein mentioned and before capital stock has been paid in, either in cash or in property honestly regarded as a fair equivalent for cash. In Rowell *v.* Janvrin[6] attention was called to the provisions of Laws of 1853, c. 333, amending the Act of 1848 by authorizing the trustees of a corporation to purchase mines, etc., and to issue in payment therefor stock to the amount of the value thereof. It was held that with respect to stock so issued "the liability still exists, however, in cases where the stock is issued for property at an excessive fraudulent or fictitious valuation to the knowledge of the trustees and for the purpose of evading the statute. Whether this rule of liability is confined to the trustees who caused the stock to be

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1 P. 194. 2 106 N. Y. 97. 3 P. 100.
4 § 10. 5 124 N. Y. 302. 6 151 N. Y. 60.

issued and to such stockholders as are chargeable with knowledge of the fraud, or applies even to innocent holders for value, is a question not entirely free from doubt, but not involved here and need not be decided." [1]

The only logical ground for a "trust fund" theory of stockholder's liability on stock issued for property in excess of its fair value is that stated by Mr. Richard C. McMurtrie,[2] as follows:

> "Stockholders who inform the public that the capital of the corporation is so much, and that it has been subscribed for or paid, cannot deprive their creditors of this fund by an arrangement among themselves, agreeing that $50 shall be a payment of $100 of the capital represented to have been paid or agreed to be paid."

That is, it must rest upon a contract, express or implied. The uncertainties attendant upon the subject arise largely out of the decisions of courts creating *implied* contracts of uncertain meaning by a strained construction of statutes which authorize the issue of shares of stock in consideration of the acquisition of property.

Some courts which refuse to accept the "trust fund" theory, find a basis on which to hold holders of stock issued for property liable for the debts of the corporation, in what is known as "the true value" rule.

> "The *true value rule*," says Judge Seymour D. Thompson,[3] "is strictly the rule of the English courts, as we understand their decisions.[4] When they use the expression 'money's worth' they mean that the property which is turned over to the corporation in payment of its shares must be turned over at a fair valuation, and they mean, further, that whether or not it has been turned over at a fair valuation may become a subject of judicial inquiry in a proceeding to charge a shareholder in favor of creditors on the ground that his shares have not been fully paid for.
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> "This rule as stated and applied in some of the American courts is, that payment of corporate stock in anything except money will not be regarded as payment except to the extent of the true value of the property received in lieu of money and regardless of the question of fraud."

But, "as value is largely a matter of opinion, anticipation, or belief," to justify a finding of fraud, "there must be actual fraudulent intent, or such reckless conduct as would indicate without explanation an intent to defraud."

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[1] See 1 Beach, Private Corporations, § 131, c.

[2] 25 Am. L. Rev. 749.

[3] 36 Cent L. J. 92.

[4] See *contra*, Companies Act 1867, § 25.

Whether the "trust fund" theory or the "true value" rule prevail, the question of the stockholder's liability is still left an open question, to become practical when the enterprise has failed, when property which may have been quite honestly and even conservatively valued has proved after exploitation or use to be actually worth much less than was estimated, and when it may be difficult or impossible to satisfy a court, besieged by clamorous creditors, that the valuation upon which the issue was based was, when made, honest and fair.

As Judge Thompson says, "value is largely a matter of opinion, anticipation, or belief," and in view of the conflicts and uncertainties evidenced by the decisions of courts above cited, the legislatures should enact some clear, definite, and easily ascertainable rule by which the question whether or not shares of stock issued in payment for property are actually full paid and non-assessable should be finally and definitely ascertained, at or near the time of issue — not years later, after the insolvency or bankruptcy of the corporation.

A few of the states have already met the question by legislation declaring that the value agreed upon between the directors and the subscribers shall be final and conclusive.[1] In England,[2] and in many of the British Colonies in America, this is so where the agreement is embodied in a contract duly filed in a public office.[3]

Besides the promoters of the enterprise, only two classes of persons have a legitimate interest in the amount and character of the corporate capital, namely: (1) those who purchase the stock or securities of the company, and (2) those who become creditors of the company, actually or impliedly relying upon what is represented to or ascertainable by them concerning its resources. The respective rights and liabilities of both of these classes have been carefully considered and protected by the English Companies Acts (1862 to 1907), and it seems strange that American legislatures have not followed the suggestions furnished by these carefully drawn and well-considered enactments.

In Hospes *v.* Northwestern Mfg. & C. Co.,[4] Mitchell, J., after finding it impossible to reconcile the decisions of the Supreme Court

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[1] Maryland, Public Gen. Laws, Art. 23, § 61; West Va. Code, c. 53, § 24, Laws 1901, c. 35, § 8; Mass. L. 1903, c. 437, § 14.

[2] The Companies Act 1867, § 25. But see The Companies Act 1900, §§ 33, 7.

[3] Masten, Companies Law of Canada, 49; Morrison, Limited Liability Companies in New Zealand, §§ 52–3.

[4] 48 Minn. 174, 197.

of the United States concerning stock issued by a "going concern," with the trust fund theory, or to predicate in the light of such decisions the liability of the stockholder upon that doctrine, says:

> "But by putting it upon the ground of fraud, and applying the old and familiar rules of law on that subject to the peculiar nature of a corporation, and the relation which its stockholders bear to it and to the public, we have at once rational and logical ground on which to stand. The capital of a corporation is the basis of its credit. It is a substitute for the individual liability of those who own its stock. People deal with it and give it credit on the faith of it. They have a right to assume that it has paid in capital to the amount which it represents itself as having; and if they give it credit on the faith of that representation, and if the representation is false, it is a fraud upon them; and in case the corporation becomes insolvent, the law, upon the plainest principles of common justice, says to the delinquent stockholder, 'make that representation good by paying for your stock.' It certainly cannot require the invention of any new doctrine in order to enforce so familiar a rule of equity. It is the misrepresentation of fact in stating the amount of capital to be greater than it is that is the true basis of the liability of the stockholder in such cases." [1]

The English Companies Acts proceed on the basis of the theory so clearly stated by Judge Mitchell, but instead of leaving the capital, which is the basis of credit, on the *assumption* that it is an amount of money equal to the nominal capital stock, these statutes require full and detailed statements of the facts to be embodied in prospectuses, where an appeal is made to the public for subscriptions, and to be filed in the office of the Registrar of Corporations.

The underlying principle of these enactments is that full and complete disclosure be made by means of verified statements, and that copies of contracts providing for the acquisition of property to pay for which shares of capital stock are to be issued shall be filed in a public office, such statements and contracts giving full detailed descriptions of all property proposed to be acquired by the company by the issue of its stock or securities, the interest of the promoters, directors, or other stockholders in such property, the cost to the vendors to the company of such property, and all profit or advantage of every kind which directly or indirectly has been or is to be reserved or secured to the organizers. If a public offering of stock or securities is to be made, the prospectus must

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[1] P. 197.

conform to the very stringent requirements of the statute, and those who issue the prospectus are held strictly liable, civilly as well as criminally, for any false representation therein or concealment of any material fact therefrom.

As early as 1867 the act amending The Companies Act, 1862, provided[1] that

> "Every share in any company shall be deemed and taken to have been issued and to be held subject to the payment of the whole amount thereof in cash, unless the same shall have been otherwise determined by a contract duly made in writing, and filed with the Register of Joint Stock Companies at or before the issue of such shares."[2]

This section was, however, repealed by The Companies Act, 1900,[3] but section 7 of said Act of 1900 requires, in case shares are issued wholly or in part for a consideration other than cash, that a contract in writing specifying the consideration for the issue and "the extent to which they are to be treated as paid up" be filed with the Registrar of Corporations.

In Matter of Wragg[4] it was held that,

> "Although a limited company cannot issue shares at a discount, it can, provided the contract is duly registered under the 25th section of the Companies Act, 1867, buy property at any price it thinks fit, and can pay for such property in fully paid-up shares; and the transaction will be valid and binding upon its creditors, if the company has acted in it honestly and not colorably, and has not been so imposed upon by the vendor as to be entitled to be relieved from its bargain."

That is to say, the transaction is conclusive unless the vendor has imposed upon the company to such extent that the company would be entitled in equity to rescind the bargain, surrender what it had received and get back the stock which it had issued in payment. This is virtually the principle on which the United States Circuit Court of Appeals decided the case of Sternbergh *v.* Duryea Power Co.,[5] above cited.

The French law deals somewhat differently with the subject. It recognizes the right to issue shares of a limited liability company (*Société Anonyme*) to represent property contributed to the corporate undertaking, as well as cash. Each subscriber or associate

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1 § 25.

2 Buckley, The Companies Acts, 8 ed. (1902), 633-4.

3 § 33.

4 [1897] 1 Ch. 796.

5 161 Fed. 540.

is considered as debtor to the company for what he has promised to pay or contribute. The aggregate of the agreed contributions of all the associates constitutes the company's capital.[1]

But the Commercial Code provides that the valuations of property forming the basis of shares of capital stock, and any particular advantages secured to any of the shareholders shall not be final and binding until the same shall have been submitted to and approved by two successive general meetings of the shareholders,[2] no interested stockholder having the right to vote thereon. The law of 1893 also forbids the negotiation of shares issued for property in such manner as to relieve the original taker, until the expiration of two years after the organization of the company. After the expiration of two years, and the approval by two successive general meetings of the shareholders, and upon the payment or delivery to the company of the agreed contribution, whether in money or property, the stock is conclusively held to be full paid and non-assessable. The certificates representing this stock may be either in the name of the owner[3] or to bearer; in the latter case transferable by delivery merely.

From the foregoing it is apparent that much confusion of thought as to the capital of a corporation has resulted in conflict in both legislative and judicial dealings with the subject. The real evil is not so much in over-capitalization, or in exaggerated valuation of property constituting a part of the capital stock as it is in the misrepresentation or concealment of material facts in soliciting financial aid for the corporation. If instead of creating by strained construction and forced analogies *ex post facto* contracts between subscribers and the corporation, courts would respect the finality of rules laid down by the legislature, and deal with cases of fraudulent misrepresentation or concealment by the application of well settled principles, and if the laws were modified so as to require full, frank disclosure of all the facts concerning the property serving as a basis for stock issue, and safeguards as to its valuation, and some method by which, after due opportunity had been given for full investigation, such determination should be final, the so-called evils of over-capitalization would largely disappear.

NEW YORK. *George W. Wickersham.*

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[1] Traité de Droit Commercial CH. Lyon-Caen et Renault, Paris 1898, Tome II. pp. 388, 559, 560.

[2] 2 Lyon-Caen, 537, 574.

[3] Code de Commerce, Arts. 35, 36; Lyon-Caen, V. II. p. 445.